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United States Government Shutdown and Debt Limit: Answers to Frequently Asked Questions

RATINGS

United States of America

FC Government Bond Rating	Aaa/STA
LC Government Bond Rating	Aaa/STA
FC Bond Ceiling	Aaa
LC Bond Ceiling	Aaa

KEY INDICATORS

	2012	2013F
Real GDP (% change)	2.8	1.8
Fed. Gov. Financial Balance/GDP (%)	-6.8	-3.8
Fed. Gov. Debt/GDP (%)	70.1	72.5
Fed. Gov. Int./Rev. (%)	9.3	7.6

Source: Moody's Investors Service, National Sources

Analyst Contacts:

NEW YORK +1.212.553.1653

Steven A. Hess +1.212.553.4741
Senior Vice President
steven.hess@moodys.com

Atsi Sheth +1.212.553.4873
Vice President - Senior Credit Officer
atsi.sheth@moodys.com

Bart Oosterveld +1.212.553.7914
Managing Director - Sovereign Risk
bart.oosterveld@moodys.com

Two separate issues now affect the near-term outlook for US government finances: the government shutdown and the debt limit. The government shutdown began 1 October and resulted from Congressional inaction to authorize spending through either a budget or a continuing resolution. The US government (Aaa stable) reached its statutory debt limit of $16.7 trillion on 19 May. Since then, the US Treasury has used "extraordinary measures" to raise funds and pay government expenditures. Treasury estimates that it will exhaust those measures on 17 October and government expenditures will have to be reduced.

Below, we address key questions stemming from the US government shutdown and the failure to raise the debt limit.

» **How does the government shutdown affect US creditworthiness?** The shutdown has no effect on the government's ability to pay interest and principal on its debt obligations, and therefore does not directly affect the government's creditworthiness. The shutdown prohibits discretionary spending, but not mandatory spending or debt service, such as interest and principal on Treasury securities, which the US government will continue to be able to pay.

» **Will the government default after 17 October if the debt limit is not raised?** We believe the government would continue to pay interest and principal on its debt even in the event that the debt limit is not raised, leaving its creditworthiness intact. The debt limit restricts government expenditures to the amount of its incoming revenues; it does not prohibit the government from servicing its debt. There is no direct connection between the debt limit (actually the exhaustion of the Treasury's extraordinary measures to raise funds) and a default.

» **What is the pattern of US interest payments after 17 October?** Interest payments on Treasury bonds and notes are due twice monthly, on the 15th and the last day of every month. After 17 October, the first interest payment date is 31 October, when a relatively small $5.9 billion is due, and the next is 15 November, when $30.9 billion is due.

» **Why are only interest payments potentially affected and not principal?** The statutory debt limit is a limit on the amount of debt outstanding. As debt matures, it can be refinanced with new Treasury issuance without affecting the total amount of debt (principal). Interest, by contrast, is an expenditure and could be included among the expenses that the Treasury could decide not to pay.

» **Is the situation worse now than it was in 2011, the last time that the debt limit was an issue?** No. The budget deficit was considerably larger in 2011 than it is currently, so the magnitude of the necessary spending cuts needed after 17 October is lower now than it was then.

» **Could the government take other steps to finance itself without increasing debt?** Although we consider it unlikely, the government could pursue a variety of options to finance itself, from asset-backed sales or swaps of gold reserves or other assets to invoking the 14^{th} Amendment. Congress could also decide to repeat its prior suspension of the debt limit while further negotiations take place.

Detailed Discussion

How does the government shutdown affect US creditworthiness?

The US government shutdown on 1 October resulted from Congressional inaction to authorize spending through either a budget or a continuing resolution. It prohibits discretionary spending, which includes most day-to-day operations of the government. However, mandatory spending, which includes major social programs such Social Security, Medicare, Medicaid and income support programs can continue normally during the government shutdown. Importantly, the shutdown does not affect the payment of debt service on Treasury securities, so the government's creditworthiness is not directly affected.

Since 2011, a series of continuing resolutions have authorized government spending because no budgets have been passed. Discretionary spending amounts to about 38% of the government's non-interest spending, but the shutdown has numerous exceptions for activities considered essential. Therefore, the reduction to total government non-interest spending for the duration of the shutdown could be considerably less than the 38% figure would imply.

If the shutdown lasts for an extended period, it could have economic effects that would eventually affect government revenues, but lower expenditures would also continue, so that budget deficits would likely decline. If short-lived, the economic and revenue consequences of the shutdown will be minimal.

Congress' failure to raise the statutory debt limit presents a theoretically larger threat to the government's ability to service its debt.

Will the government default after 17 October if the debt limit is not raised?

There is no direct connection between the debt limit, which was reached last May, and a default. On 17 October, however, the government is expected to have less revenue and cash on hand than committed expenses, so some bills may not be paid. If that occurs, the government will have to prioritize among its expenditures. We continue to believe that the government will prioritize its debt payments.

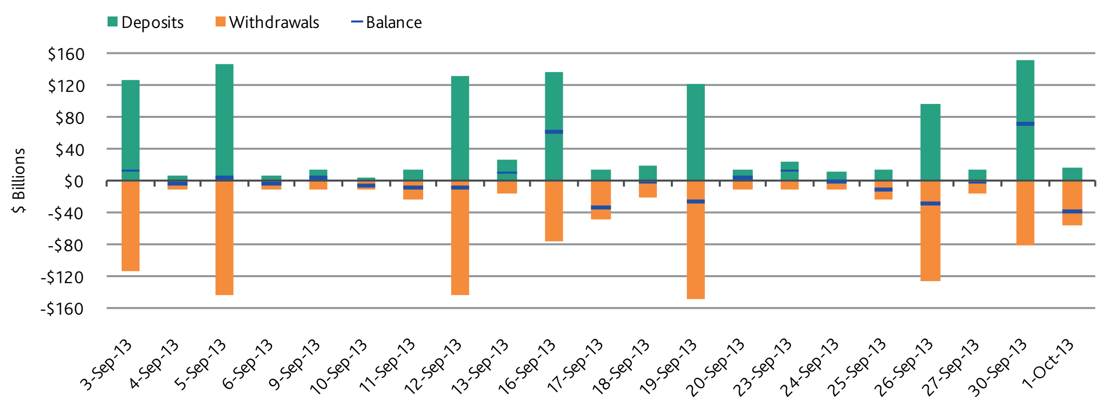
No interest payments are due until 31 October, when $5.9 billion in interest is to be paid. Thus, a Treasury bond default is not technically possible until that date. Moreover, given that the amount that needs to be paid is relatively small, a default is also extremely unlikely.

According to the Treasury Secretary Jack Lew, the Treasury's extraordinary measures to finance government spending (since the $16.7 trillion debt limit was reached in May) will be exhausted sometime around 17 October. The Congressional Budget Office (CBO) estimates the date between 22 October and the end of the month.

When the extraordinary measures are exhausted, the government's expenditures will be limited to the amount of incoming revenues, since it is not authorized to increase its stock of debt. These revenues change day to day. During September, for example, the daily receipts of the Treasury varied from $5.8 billion to $152.0 billion, averaging $55.4 billion daily. Daily expenditures also show considerable variation, from $9.9 billion to $147.2 billion and averaged $52.3 billion. The excess of revenue over expenditure meant that, on a cash basis, the government recorded a surplus for the month of September. This results mainly from the schedule of corporate tax payments; the government also recorded a surplus in September 2012.

EXHIBIT 1

Daily US Treasury Cash Balance During September 2013



Source: US Treasury, Moody's

However, if the debt limit is not raised by November, the government will face the prospect of a month when revenues fall short of scheduled expenditures by a significant margin. In November 2012, expenditures were more than double revenues, resulting in a $172 billion cash deficit.

Given that the Treasury will exhaust extraordinary measures to raise funds in the second half of October, November is the first month the government will have to select which obligations it will meet if the debt limit is not raised. The government has not indicated which obligations it would meet in such a scenario. If the shutdown is still in effect by the start of November, discretionary spending will be severely limited, so that some of the choices will have already been made. If the shutdown has been lifted by the start of November, then the rationing of payments will be at the discretion of Treasury and the Office of Management of Budget. In our view the government is very likely to manage to prioritize interest payments because of the potentially serious effects of a default on financial markets not only in the US, but globally.

What is the pattern of US interest payments after 17 October?

Interest payments on Treasury bonds and notes are due twice monthly, on the 15th and the last day of every month. For 31 October, the $5.9 billion in interest payable is a relatively small amount.

However, on 15 November, interest totaling $31 billion is due. This, plus the $6 billion payment due at the end of November, would be equivalent to about 18% of our estimate of the government's revenues for the month. Therefore, if the government gives priority to paying interest, as we believe it will, it will have sufficient resources to do so.

EXHIBIT 2

US Federal Government Interest Payments Due in Fourth-Quarter 2013

		Amount of Principal Affected $ Billions	Principal/ Total Debt Outstanding (excluding T-Bills) $ Billions	Interest Payments $ Billion	Interest Payments/ Revenue
October	15th	$418	4.2%	$1.8	3.7%
	31st	$773	7.8%	$5.9	
November	15th	$1,768	17.8%	$30.9	18.9%
	30th	$776	7.8%	$5.6	
December	15th	$196	2.0%	$0.5	2.0%
	31st	$776	7.8%	$6.1	

Source: US Treasury, CBO, Moody's

Why are only interest payments potentially affected and not principal?

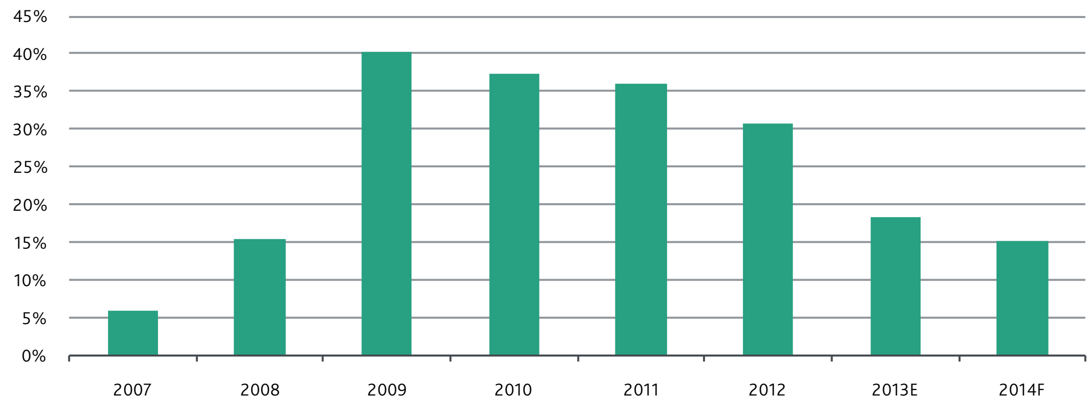
The statutory debt limit is a limit on the amount of debt outstanding. As debt matures, it can be refinanced without affecting the total amount of debt. Interest, however, is an expenditure and is potentially affected in the process of cutting expenditures. The ability to refinance is, of course, dependent on market confidence. As the global reserve currency and financial market benchmark, it is very unlikely that the US will lose market access, since the debt limit question does not affect its long-term debt-servicing capacity. However, yields on Treasury securities may well rise in coming weeks if there is no increase in the debt limit.

Is the situation worse now than in 2011, the last time that the debt limit was an issue?

No. By comparison, the budget deficit (the amount of spending financed by borrowing) was considerably larger in 2011 than it is currently, so that the magnitude of the necessary spending cuts is now lower than it was then. This is shown in Exhibit 3. In July 2011, we placed the US government bond rating on review for downgrade because the probability of a missed interest payment on Treasury bonds was rising, but still low. At the time, we believed that the government would continue to service its debt even if the debt limit were not raised.

EXHIBIT 3

US Federal Government Deficit as Percent of Total Expenditures



Source: US Treasury, CBO, Moody's

Can the government take other steps to finance itself without increasing debt?

The government could take a number of steps to finance itself without recourse to borrowing. We believe these are unlikely to be implemented, but they include:

» **Sales/swaps of gold**. The US has 261.5 million ounces of gold. At current market prices, this is valued at over $300 billion

» **Minting coins in large denominations** that would be deposited with the federal reserve in exchange for cash

» **Asset-based lease-backs, sales or swaps** involving property or other assets

» In addition, some commentators believe that the administration could continue to borrow by **invoking the 14th Amendment to the constitution**, which states that no one shall question the validity of US debt. It is unclear whether the courts would deem this action constitutional

» Finally, Congress could, as it did earlier this year, **suspend the debt limit** while further negotiations occur. This seems unlikely in the current political conjuncture, but a precedent has been set

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Author
Steven Hess

Associate Analyst
Renzo Merino

Financial Writer
Maya Penrose

Production Associate
David Dombrovskis

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